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IN THE

Supreme Court of the United States

OCTOBER TERM 1956

No. 804

JOSEPH KANE,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

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IN THE

Supreme Court of the United States

OCTOBER TERM 1956

JOSEPH KANE, *Petitioner,* v. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	No.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit, entered December 5, 1956, sustaining the decisions of the Tax Court of the United States in the above-entitled proceedings.

Citations to Opinions Below

The findings of fact and opinion of the Tax Court of the United States (R. 5-25) is reported in 25 T. C. 1112. The United States Court of Appeals for the Second Circuit affirmed per curiam on December 5, 1956, not yet officially reported.

Jurisdiction

The United States Court of Appeals for the Second Circuit, having affirmed the decisions of the Tax Court of the United States on December 5, 1956, the jurisdiction of this Court is invoked under 28 U. S. C. Section 1254(a).

Questions Presented

I.

Did the petitioner realize any taxable income upon the exercise in 1945, 1946 and 1947 by petitioner's wife of a stock option granted to her by Arde Bulova to purchase stock of the Bulova Watch Co. Inc. (petitioner's prospective employer) owned by him personally where (a) at the time the option was granted the market price was not in excess of the option price; (b) petitioner's wife used her own funds in acquiring such option-stock, kept the stock and the dividends therefrom and reaped the benefits of such ownership; (c) it has been stipulated that no stock option had been granted to petitioner prior to March 31, 1947; and (d) neither Arde Bulova nor the Bulova Watch Co. Inc. claimed or was allowed any deduction from income by reason of the granting or exercise of the stock option?

II.

In the alternative, assuming, arguendo, that the stock option was granted in 1944 to or for the benefit of petitioner, does not the agreement between Arde Bulova and petitioner's wife effectively work an assignment of such option and therefore limit petitioner's taxable gain to the appreciation in value of the stock option to the assignment date?

III.

In the second alternative, accepting, arguendo, that the stock option agreement was for the benefit of the petitioner, is not the increase in value of the option-stock, measured by the difference between the option price and the market value of the stock on the date of exercise, exempt from tax

in the light of the rationale of the U. S. Supreme Court decision in *Palmer* v. *Commissioner of Internal Revenue*, 302 U. S. 63?

IV.

In the third alternative, may the Commissioner of Internal Revenue arbitrarily apply or withhold the application of Regulations 111 Section 29.22(a)-1 as interpreted by I. T. 3795 issued in April 1946, so as to discriminate among taxpayers?

Statement

Petitioner duly filed petitions for the redetermination of the deficiencies set forth by the Commissioner of Internal Revenue in his "90-day" deficiency notices with the Tax Court of the United States, Docket Nos. 50587 and 52755. On July 14, 1954, a motion to consolidate these cases was granted. The Tax Court filed its findings of fact and opinion and entered its decisions on February 29, 1956.

A motion by petitioner for full review by the Tax Court of the United States was denied by the Tax Court on March 8, 1956. On May 17, 1956, petition for review was filed with the U. S. Court of Appeals for the Second Circuit which affirmed the decision of the Tax Court of the United States on December 5, 1956.

The Tax Court of the United States determined that petitioner, Joseph Kane, realized ordinary taxable income in the calendar years 1945, 1946 and 1947 of $11,100, $19,650 and $12,200, respectively, by reason of the exercise by petitioner's wife, Rose, of an option to purchase stock of the Bulova Watch Co. Inc., which option was granted to her by Arde Bulova on 1,000 shares of his personally owned stock in that corporation at $37 per share.

The Tax Court held that the option to purchase the stock was intended as additional compensation for the husband's services and that the excess of the market value of the stock over the option price in each year in which stock was purchased by Rose Kane under the option was taxable income to her husband Joseph, under Section 22(a) of the Internal Revenue Code of 1939.

Reasons for the Granting of the Writ

(1) The decisions of the Court below in the instant proceeding involve the proper legal construction of Federal income tax statutes as set forth in the U. S. Internal Revenue Code of 1939 and regulations and rulings promulgated thereunder intended to implement such statutes.

The fundamental question involved in this application for a Writ of Certiorari is whether the petitioner is taxable under Section 22(a) of the U. S. Internal Revenue Code of 1939 on income alleged to arise by reason of the exercise by petitioner's wife, Rose, of an option to acquire stock in the Bulova Watch Co., Inc., granted to her by Arde Bulova, a 19% stockholder of the Bulova Watch Co., Inc., from his personally owned stock in said corporation.

The agreed and uncontroverted facts of this proceeding are that petitioner's wife used her own personal funds to acquire the stock from Arde Bulova and that she kept the stock and income therefrom at all times, and that neither the stock nor the income therefrom was ever turned over to or used by the petitioner in any manner whatsoever (R. 8, 9, 14); that at the time the option was granted in 1944, the market price of such option shares was not in excess of the option price. (A. 19).

The Tax Court has misconstrued this stipulated fact and labored under the impression that the said stipulation related to August 17, 1944. However, on that date the

market value was approximately $40 per share, as was noted by respondent on page 5 of his brief to the U. S. Court of Appeals, Second Circuit. Paragraph 5 of the stipulation (A. 19) referred to the date the option was granted, which was a few months prior to August 1944. (R. 8, 9)

On the dates the stock was purchased, namely, December 27, 1945, August 6, 1946 and July 2, 1947, the market price exceeded the option price in the amounts of $11,100, $19,650 and $12,200, respectively (R. 15); that at no time was petitioner's wife an employee of either Arde Bulova or the Bulova Watch Co., Inc., (R. 6); that petitioner was not an employee of Arde Bulova personally and that no stock option of any kind has been issued by Bulova Watch Co., Inc. or Arde Bulova to an employee of either prior to March 31, 1947. (R. 12)

This last finding of fact, which was stipulated to, standing alone, should preclude a finding that the option granted to Rose Kane by Arde Bulova was in reality an option granted to Joseph, an employee of the Bulova Watch Co., Inc.

The Tax Court further found that the employment agreement between Bulova Watch Co. Inc. and petitioner, exclusive of any alleged stock option, yielded greater compensation to the petitioner than he formerly had received from the Gruen Watch Co., petitioner's former employer (R. 21).

No person testified in the instant proceeding that the stock option given to Rose Kane was intended as compensation to petitioner or was intended to induce petitioner to accept employment. To the contrary, all persons who were in the best position to know the facts, including petitioner, his wife, Rose, and Arde Bulova, the grantor of the stock option, testified the option was not intended as compensation to petitioner (R. 19, 36) but was granted to Rose Kane

to assuage her personal unhappiness in giving up her home, her friends and her social position in Cincinnati, Ohio, and in a measure to provide a means for possible future reimbursement for losses suffered by Rose in giving up her home in Cincinnati and the expense incident to moving to New York City (R. 34, 41).

Furthermore, neither the Bulova Watch Co. Inc. nor Arde Bulova claimed or were allowed any deduction for the amounts alleged to constitute compensation to petitioner in the year the option was granted or exercised (R. 14).

The basis for the Tax Court's opinion was that it considered the granting of the option a "clincher" for the petitioner to accept employment (R. 24). The Tax Court spelled out the option as part of the employment arrangement, not from any testimony or from any written documents which stated that the option was part of the terms of employment, but from a clause in the option agreement which stated that the shares could be purchased—300 during the first year, 300 during the second year and 400 during the third year of petitioner's employment by the Bulova Watch Co. Inc. Arde Bulova testified that he used such terminology only because he did not think Mrs. Kane could finance the whole purchase at one time, though he would have allowed her to do so at any time (R. 37). The Tax Court has read into the employment agreement terms not expressed therein. The employment agreement is not ambiguous; there has been no dispute between the parties to the agreement as to the meaning of its terms; and there is no basis for the Court to alter what is expressly stated therein.

Any alleged ambiguity between the testimony of the witnesses and statements contained in the option agreement was adequately explained by Arde Bulova and Rose Kane.

The Tax Court found that Arde Bulova knew at the time the option agreement was granted to Rose Kane that

a stock split-up would occur a year later and that such knowledge was indicative that the option agreement was an additional inducement to the petitioner to accept employment with Bulova Watch Co. Inc. (R. 22). No testimony was requested or given to this effect. On the contrary, though Arde Bulova subsequently recognized the stock split by allowing Rose Kane to buy double the number of shares at half the price stated in the option agreement, the option agreement itself failed to even mention what adjustment of the option price or of the number of shares would be necessary in the event of a stock split-up. This is the best proof that a split-up had not been contemplated on the date the option was granted and the Tax Court erred when it considered such stock split-up a material factor in arriving at its ultimate conclusion that the option was intended as compensation to petitioner.

The fact that the written agreement between the Bulova Watch Co. Inc. and petitioner and the option agreement between Arde Bulova and petitioner's wife, were dated the same date was considered by the Tax Court as an additional circumstance establishing that the option agreement and the employment agreement were but one transaction. However, the evidence in the case clearly establishes that the agreements of petitioner with Bulova Watch Co. Inc. and petitioner's wife with Arde Bulova were separately and independently arrived at a long time before the agreements were reduced to writing; that petitioner's wife had already given up her home in May 1944 (R. 9) and moved to New York and that the simultaneous dating was only a matter of convenience when all parties were available in New York City during a summer vacation period (R. 9, 35).

Fundamentally, the Tax Court went far afield to arrive at its ultimate conclusion of fact that the stock option to petitioner's wife, Rose, was part of the employment agreement between Bulova Watch Co. Inc. and petitioner, and

thus constituted taxable income under Section 22(a) of the U. S. Internal Revenue Code of 1939.

In applying the law to the facts in this proceeding the Tax Court compared this case with the cases of *Lucas* v. *Earl,* 281 U. S. 111, *Burnet* v. *Leininger,* 285 U. S. 136, and *Helvering* v. *Horst,* 311 U. S. 112 (R. 25). Those cases stand for the proposition that a taxpayer cannot avoid tax by anticipatory assignment of income.

In applying those cases the Court, as well as respondent, treated Rose Kane, on the one hand, as the owner of the stock bought under the option and taxable on the dividends therefrom (R. 14) while at the same time treated petitioner as the owner of the option—a position that is highly contradictory, particularly since Rose owned the option for 16 months before the option was exercised.

The Tax Court, by treating the option as petitioner's, is transferring an asset from one spouse to the other, though it recognizes that the income of each is separately taxable. The Internal Revenue Code of 1939 allows separate returns to be filed by each spouse and they were so filed (R. 6).

The Tax Court's decision would in effect destroy the right of married persons to have their own separate assets and income. A dramatic illustration of the consequences of the Tax Court's decision would be a divorce during the option period. In such event, would the Court hold that petitioner had to pay a tax on the increase in the value of the option when exercised even though he had no right to the stock and all the economic gains accrued to the divorced wife?

The Tax Court evidently misunderstood and misapplied the principles of *Commissioner of Internal Revenue* v. *Smith,* 324 U. S. 177. The Smith case pertained to an option granted to an *employee* to acquire the *assets of the employer* to be received by the employer as a result of the

efforts of the employee. When the assets were so received by the employer corporation and thereafter transferred to Smith for a nominal consideration, the value of such assets was greatly in excess of the option price. Obviously the transfer of corporate assets to an employee at substantially less than fair market value admittedly given in consideration of services rendered constitutes taxable income, and the Supreme Court so held.

Those are not the facts in this proceeding.

In the case of the *Commissioner of Internal Revenue* v. *LoBue,* 351 U. S. 243, the employee, LoBue, received a *non-transferable* stock option to buy stock of the employer-corporation from the *employer* at a price considerably below the market price of such stock on the date the option was granted. The Supreme Court agreed with the Commissioner of Internal Revenue that the stock of the employer was transferred to LoBue to secure better services and thus was plainly compensation. However, the Supreme Court did say that options may have an ascertainable market value when received, and if the option were transferable, the receipt of a stock option could result in immediate taxable income. A foot note in the LoBue case indicated that such a condition existed in *McNamara* v. *Commissioner of Internal Revenue,* 210 F. (2d) 505 (C.A.-7, 1954).

A similar observation that a stock option might under certain circumstances constitute taxable gain on its receipt is also made in the *Smith* case previously referred to.

The decision in *Wanda Van Dusen* v. *Commissioner of Internal Revenue,* 166 F. (2d) 647, relied on by the Tax Court below, can easily be distinguished on its facts. In that case the option was given to the *employee,* Van Dusen, by the president of the corporation, Fleet, who owned 45% of the stock of the employer, to acquire stock of the corporation from the president at a price of $5. per share;

the number of shares were limited to 50 per month, as long as the employee and Fleet were employees of the corporation. At the date the option was granted, the market price was $9. per share. The Circuit Court held there was no question that the option was intended as compensation and *Fleet, the optionor, so testified.*

In this proceeding, Arde Bulova, the grantor of the option, testified that the option *was not intended* as compensation and was in fact granted to Rose Kane and *not to petitioner*. In the *Van Dusen* case, Fleet, the grantor of the option, testified that the option was granted as compensation to obtain and retain the services of Van Dusen for the corporation.

In the *Van Dusen* case, the grantor's own income was measured by the successful efforts of the employee, and furthermore, he owned 45% of the corporation, whereas Bulova's compensation did not in any manner depend on the efforts of this petitioner, and his 19% ownership would not justify him in granting the option because he might indirectly benefit.

The conclusion is inescapable that the option not having been given to the petitioner but to another taxpayer, Rose, and not by an employer, any income arising from the exercise of said option would be taxable to her and not to petitioner, especially where she acquired the stock with her own funds, received and retained the dividends, was entitled to all the benefits of ownership and was the owner of the option for 16 months prior to its exercise by her.

In *Bogardus* v. *Commissioner of Internal Revenue*, 302 U. S. 34, the Supreme Court held that payments voluntarily made by a corporation to individuals who were neither employees of the corporation or its stockholders, nor stockholders of the paying corporation, did not result in taxable income to recipients under the broad provisions of Section 22(a) of the tax statutes, even though the re-

cipients had been employees of a predecessor corporation. The applicability of this case to instant petitioner is obvious. He was not a stockholder in Bulova Watch Co., Inc. and the option rights, even if considered his, were not received from any employer.

If petitioner did derive taxable income from the option given to his wife to buy from Arde Bulova stock in the Bulova Watch Co., Inc., said income would be taxable in 1944 upon the receipt of the option and limited to the fair market value of the option when received in accordance with the decision in *McNamara* v. *Commissioner of Internal Revenue,* 210 F. (2d) 505.

In that case the U. S. Court of Appeals, Seventh Circuit, held that the taxable income of taxpayer was limited to the market value of the option at the time of its receipt where said option was a transferable one.

If the option in question in this proceeding is deemed to have been petitioner's, there is no question it was a transferable one, otherwise it could not have been given to Rose. Moreover, the agreement itself contained no restriction on further assignments by Rose, should she have so desired.

On the date the option was reduced to writing, the market price of the stock was approximately $3 per share higher than the option price as the respondent pointed out in his brief, page 5, to the U. S. Court of Appeals, Second Circuit. Therefore, the second requirement of immediate market value (a long term "call" on stock $3 per share under current market) is present.

Clearly the decisions of the Second and Seventh Circuits, U. S. Courts of Appeal, are in conflict and the Supreme Court should grant the writ of certiorari requested and settle the difference in applicable legal principles.

The situation present in the instant proceeding and the *McNamara* case was envisioned by the Supreme Court

in *Smith* v. *Commissioner of Internal Revenue,* 324 U. S. 177, when the Court stated, on page 181 of that opinion:

> "When option price is less than the market price of the property for the purchase of which the option was given, it may have present value and may be found to be compensation for services rendered."

2. In the alternative, if the option granted in 1944 by Arde Bulova to petitioner's wife, Rose, were considered to have been originally granted to or for the benefit of petitioner, then such option agreement to Rose, in effect, worked an assignment and thus limited petitioner's taxable income, if any, to the value of the option on the date of assignment.

There is no question that the option itself was a property right and the [redacted] one who had the right to exercise the option, and therefore owned the property right, was Rose. Any gains that accrue thereafter perforce belong to the owner of the rights.

In *Helvering* v. *Horst,* 311 U. S. 112, the Supreme Court in holding that an assignor was taxable on the income of the transferred interest coupons detached from the bonds, distinguished such ruling from the instance of "rent from a lease or a crop raised on a farm after the leasehold or farm had been given away. *Blair* v. *Commissioner,* 300 U. S. 12, 13."

In the instant proceeding, even if the option were considered to have been petitioner's originally, which is contrary to a specific stipulation of fact, the option was "given away" to petitioner's wife a full 16 months before exercise, and any gain accruing during that period should not be taxable to petitioner.

In *Reece* v. *Commissioner of Internal Revenue,* 233 F. (2d) 30, the U. S. Court of Appeals for the First Circuit held that no taxable income was derived by assignor after property (in this case right to royalties) was assigned to taxpayer's wife.

As a practical matter, the U. S. Courts of Appeals for the First and Second Circuits are applying different legal principles in determining who is taxable on income arising subsequent to the date of assignment.

Under the facts in this proceeding, there was no anticipatory assignment of income. On the date the option was orally granted to Rose by Arde Bulova, the market price of the stock did not exceed the option price (A-19). If the date the option was reduced to writing is treated as the controlling date, the market price of the stock was approximately $3 per share higher than the option price and any taxable income must be limited to 1944 and in that amount.

3. Assuming, arguendo, that the option agreement between Arde Bulova and petitioner's wife was for the benefit of petitioner, then petitioner is exempt from taxation on any increase in value of the option rights, in accordance with the rationale of *Palmer* v. *Commissioner of Internal Revenue,* 302 U. S. 63.

In the Palmer case, the Commissioner of Internal Revenue sought to tax the petitioner (under the broad application of Section 22 of the U. S. Internal Revenue Statutes) on the appreciation in value of subscription stock rights, measured by the difference between the market value of the stock being purchased on the date of the exercise of rights and the subscription price, as a dividend on the theory that property was being transferred to a stockholder by the corporation at a price substantially below the market price. This Court held that where the corporation transfers to its stockholders rights to acquire assets at a reasonable price and the value rises between the date of issuance of such rights and the date of actual delivery of the assets, taxable income does not result. The Court stated,

> "When the corporation has committed itself to a sale of its assets to stockholders at present market value, the effect on its balance sheet is the same as in the case of other vendors who in various ways assume the risk of rising prices pending the consummation of the sale. In every sale purchasers may, as a result of market change, acquire property at less than its value on the date of acquisition. But in the case of the corporation, it does not follow that there has been a distribution of its profits. It can hardly be said that profits accrue to a corporation from a fortuitous gain in market value, the benefits of which it has relinquished before the gain occurs."

Section 29.22(a)-1, of Treasury Regulations 111 promulgated under the Internal Revenue Code of 1939 and applicable to this proceeding groups in the very same sentence transfers of property "by a corporation to a shareholder, or by an employer to an employee, for an amount substantially less than its fair market value." This very juxtaposition of words indicates Congressional intent that both transfers from corporations to stockholders and employers to employees should be treated alike. The rationale contained in *Palmer* v. *Commissioner of Internal Revenue, supra,* is therefore applicable to this proceeding.

4. In the final alternative, even assuming, arguendo, that the option granted to Rose Kane by Arde Bulova was in fact to petitioner, petitioner contends that Regulations 111, Section 29.22(a)-1 (as interpreted by I. T. 3795 issued in April 1946) in effect for the taxable years involved in this proceeding with respect to stock options granted prior to February 28, 1945 expressly excludes from income the appreciation in value of certain employee stock options from the option date to the exercise date. The respondent may not, after publishing and applying said principle of law for many years and which has received implied Congressional

approval by enactment of tax statutes with no change being made, refuse to apply said provisions to the instant case of petitioner.

The option at issue conforms to the definitive requirements since under the stipulated facts of this case the option was given in 1944 at a time when the market price was not in excess of the option price and no deduction attributable to any aspect of the option was claimed at any time.

At the minimum the issuance of I. T. 3795 confirming prior interpretations of regulations under Section 22 of the tax statutes must govern the exercise of stock options in 1946 and 1947 which exercise occurred after the issuance of I. T. 3795.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

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THE TAX COURT OF THE UNITED STATES

JOSEPH KANE, *Petitioner,* v. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	Docket No. 50587 Docket No. 52755
ROSE KANE, *Petitioner,* v. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	Docket No. 52756

STIPULATION OF FACTS

It is hereby stipulated and agreed by and between the parties hereto by their respective counsel, that the following facts shall be taken as true, provided, however, that this stipulation shall be without prejudice to the rights of either party to introduce other and further evidence not inconsistent with the facts herein stipulated to be taken as true.

1. Petitioners, Rose Kane and Joseph Kane, resided at Avondale, Cincinnati, Ohio, until May 1944.

2. In August 1944, Joseph Kane was employed by Bulova Watch Co. Inc. as Assistant to the President, John H. Ballard, for a period of three years at a starting salary of $400 per week, increased by $100 per week in each of the next two years, plus a percentage of the net profits. A copy of the employment contract is attached as Exhibit 1-A.

TCR-102

3. Joseph Kane's place of employment with Bulova Watch Co. Inc. was in New York, N. Y. The contents of

NOTE: TCR Refers to Tax Court page as certified to U. S. Court of Appeals.

petitioner's home at Cincinnati, Ohio, was sold at auction in May, 1944.

4. On August 17, Arde Bulova addressed a letter to Rose Kane, a copy of which is attached as Exhibit 2-B.

5. The option price in Exhibit 2-B was in excess of the market price at the time the option was granted.

6. The Common Stock of Bulova Watch Co. Inc. was split two for one on July 24, 1945.

7. In accordance with the option agreement, Arde Bulova caused to be transferred 600 shares (stock split 2 for 1) of Bulova Watch Co. Inc. Common Stock on December 27, 1945 for $11,100, 600 shares on August 6, 1946 for $11,100, and 800 shares on July 21, 1947 for $14,800. The market values on the respective dates the options were exercised was $22,300, $30,750 and $27,000. The certificates of stock were issued to Rose Kane.

8. Checks, photostatic copies of which are attached as Exhibits 3-C, 4-D and 5-E, to Arde Bulova for $11,100, $11,100 and $14,800 were drawn by Rose Kane on a checking account in her own name.

9. Rose Kane was not employed by Arde Bulova, or Bulova Watch Co. Inc. at the time she received the options or at any time subsequent thereto.

10. Arde Bulova reported the sales of Bulova Watch Co. Inc. stock to Rose Kane as capital transactions and did not claim deductions for the excess of the market price at the time the options were exercised over the amounts received.

11. No stock options had been issued up to March 31, 1947, by the Bulova Watch Co. Inc. or Arde Bulova, to any employees of Bulova Watch Co. Inc. TCR-103

12. The authorized and outstanding capital stock of Bulova Watch Co. Inc. at March 31, 1945, 1946 and 1947 was as follows:

	Authorized	Outstanding
March 31, 1945	500,000 shs.	324,881 shs.
March 31, 1946	1,000,000 "	649,762 "
March 31, 1947	1,000,000 "	649,762 "

13. During the years involved in this proceeding Arde Bulova owned between 16% and 19% of the capital stock of Bulova Watch Co. Inc. The shares owned by the next largest stockholder was 3.16%.

14. Rose Kane and Joseph Kane filed separate individual Federal income tax returns for 1945, 1946 and 1947.

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May 4, 1955

STATUTES, REGULATIONS AND RULINGS INVOLVED

Pertinent provisions of the U. S. Internal Revenue Code of 1939 adopted by Act of February 10, 1939, Chap. 2, 53 Stat. 1-504 applicable to this proceeding are:

Section 22(a) Gross Income

General Definition—"Gross Income" includes gains, profits and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, of any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

(b) Exclusions from Gross Income.

The following items shall not be included in gross income and shall be exempt from taxation under this chapter.

(3) Gifts, bequests, devises and inheritances.

The value of property acquired by gift, bequest, devise or inheritance.

There shall not be excluded from gross income under this paragraph, the income from such property, or, in case the gift, bequest, devise, or inheritance is of income from property, the amount of such income. For the purpose of this paragraph, if, under the terms of the gift, bequest, devise, or inheritance, payment, crediting or distribution thereof is to be made at intervals, to the extent that it is paid

or credited or to be distributed out of income from property, it shall be considered a gift, bequest, devise, or inheritance of income from property;"

REGULATION 111

Section 29.22(a)-1 (Original Oct. 26, 1943).

What included in gross income.—

Gross Income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. (See Sections 22(b) and 116). In general, income is the gain derived from capital, from labor, or from both combined provided it be understood to include profit gained through a sale or conversion of capital assets. Profits of citizens, residents, or domestic corporations derived from sales in foreign commerce must be included in their gross income; but special provisions are made for nonresident aliens and foreign corporations by Sections 211 to 237, inclusive, and in certain cases, by Section 251, for citizens and domestic corporations deriving income from sources within possessions of the United States. Income may be in the form of cash or of property.

If property is transferred by a corporation to a shareholder, or by an employer to an employee, for an amount substantially less than its fair market value, regardless of whether the transfer is in the guise of a sale or exchange, such shareholder or employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value to the extent that such difference is in the nature of (1) compensation for services rendered or to be rendered or (2) a distribution of earnings or profits taxable as a dividend, as the case may be. In computing the gain or loss from the subsequent sale of such property its basis shall be the amount paid for the prop-

erty, increased by the amount of such difference included in gross income. This paragraph does not apply, however, to the issuance by a corporation to its shareholders of the right to subscribe to its stock as to which see Section 29.22(a)-8. * * *

Section 29.22(a)-1: 1946-8-12295

What included in gross income. I.T. 3795

Also Section 23(a), Section 29.23(a)-6;
Section 23(e), Section 29.23(e)-1.

INTERNAL REVENUE CODE

Treatment for Federal Income tax purposes of the granting to an employee of an option to purchase stock of the employer corporation, or an affiliate of the employer corporation, and the subsequent exercise, transfer or lapse of such an option.

Advice has been requested as to the income tax consequences which attach to the granting to an employee of an option to purchase stock of the employer corporation, or of an affiliate of the employer corporation as set forth in Section 141(d) of the Internal Revenue Code, and the subsequent exercise, transfer, or lapse of such an option.

Section 22(a) of the Internal Revenue Code includes in an employee's taxable income any economic or financial benefit conferred on him as compensation, whatever the form or mode by which it is effected. (See Commissioner v. John H. Smith, 324 U. S., 177, Ct. D. 1633, C. B. 1945, 49; Old Colony Trust Co. v. Commissioner, 279 U. S., 716, Ct. D. 80, C. B. VII-2,222). (1929)

Section 29.22(a)-1 of Regulations 111, as amended by Treasury Decision 5507, approved April 12, 1946, applies to options granted to employees on or after February 26, 1945, the date of the Supreme Court's decision in Commissioner v. John H. Smith, supra, and provides in part as follows:

> If property is transferred by an employer to an employee for an amount less than its fair market value, regardless of whether the transfer is in the form of a sale or exchange, the difference between the amount paid for the property and the amount of its fair market value is in the nature of compensation and shall be included in the gross income of the employee. In computing the gain or loss from the subsequent sale of such property its basis shall be the amount paid for the property, increased by the amount of such difference included in gross income.

In view of the foregoing, if an employee receives an option on or after February 26, 1945, to purchase stock of the employer corporation, or of an affiliate of the employer corporation as set forth in Section 141(d) of the Internal Revenue Code, and the employee exercises such option, the employee realizes taxable income by way of compensation on the date upon which he receives the stock to the extent of the difference between the fair market value of the stock when it is received and the price paid therefor.

If the employee transfers such option for consideration in an arm's length transaction, the employee realizes taxable income by way of compensation on the date he receives such consideration to the extent of the value of such consideration.

If the employee transfers such option in a transaction other than at arm's length and the transferee thereafter exercises the option, the employee realizes taxable income by way of compensation on the date upon which the transferee receives the stock to the extent of the difference between the fair market value of the stock at that time and the price paid therefor less the value of any consideration previously received by the employee for the transfer of the option, which latter value is taxable when received by the employee.

No deduction is allowed to the employee by reason of the lapse of such option except to the extent of any consideration in money or property previously paid by the employee for the option and not recovered by him,

such unrecovered consideration being deductible, pursuant to Section 23(e) of the Internal Revenue Code, in the year in which the option expires.

If such option is granted to the employee by the employer corporation, the amount of compensation realized by the employee under the foregoing principles is deductible by the employer corporation, in the year in which the employee realizes such compensation, to the extent set forth in Section 23(a)(1) of the Internal Revenue Code.

Treasury Decision 5507, supra, does not apply to the case of the exercise or transfer, at whatever date, of an option which was granted to an employee prior to February 26, 1945, to purchase stock of the employer corporation, or of an affiliate of the employer corporation as set forth in Section 141(d) of the Internal Revenue Code.

Accordingly, in view of the prior development of the regulations and interpretations relative to employee stock options (see T.D. 3435, C.B. II-1, 50 (1923); I.T. 3204, C.B. 1938-2, 126; T.D. 4879, C.B. 1939-1 (Part 1), 159), as respects an option granted to an employee prior to February 26, 1945, unless at the time such option was granted there was a substantial difference between the fair market value of the stock and the option price therefor, or, within the purview of Section 29.22(a)-1 of Regulations 111 prior to the amendments made by Treasury Decision 5507, supra, the employee would otherwise clearly realize income by way of compensation through the exercise or transfer of the option, this office will hold that the exercise or transfer of such option, as the case may be, does not result in income to the employee by way of compensation under the principles enunciated in the preceding paragraphs, provided, however, that on or before July 1, 1946, the employee to whom such option is granted and any transferee thereof, and the employer corporation or any other taxpayer who granted such option to the employee, file in duplicate with the Commissioner of Internal Revenue at Washington, D. C., written consents (1) agreeing that the basis to the employee,

and to any transferee of the option, for the stock acquired or to be acquired pursuant to the option shall be the actual price paid therefor and that no deduction shall at any time be claimed attributable to any aspect of the option arrangement, under Section 23(a)(1) or any other subsection of the Internal Revenue Code, by the employer corporation or the taxpayer who granted the option, and (2) indemnifying the Commissioner against the filing of a claim for credit or refund, or any other action by any taxpayer concerned, inconsistent with the consents filed.

For purposes of the preceding paragraph, in determining what constitutes a substantial difference between the fair market value of the stock and the option price in any particular case, consideration will be given, among other things, to the number of shares subject to the option, to the previous variations in fair market value of the stock, and to the type of business and history of the employer corporation and its affiliates.

JOSEPH D. NUNAN, JR.
Commissioner of
Internal Revenue

Approved April 12, 1946
JOSEPH J. O'CONNELL, JR.
Acting Secretary of
the Treasury

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In the Supreme Court of the United States

OCTOBER TERM, 1956

No. 804

JOSEPH KANE, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (R. 23–43) [1] is reported in 25 T. C. 1112. The *per curiam* opinion of the Court of Appeals (R. pp. 51–52) is reported in 238 F. 2d 624.

JURISDICTION

The judgments of the Court of Appeals (R. pp. 53–54) were entered on December 5, 1956. The petition for a writ of certiorari was filed on February 27, 1957. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

[1] Record references are to the appendix to the taxpayer's brief filed in the Court of Appeals.

QUESTION PRESENTED

Whether the record warrants the Tax Court's conclusion, affirmed by the court below, that income was realized by the taxpayer, as compensation for personal services, through the exercise of a stock option granted by taxpayer's employer to taxpayer's wife.

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1939:

> SEC. 22. GROSS INCOME.
>
> (a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *.
>
> * * * * *
>
> (26 U. S. C. 1952 ed., Sec. 22.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

> SEC. 29.22 (a)–1. *What Included in Gross Income.*—* * *
>
> If property is transferred by a corporation to a shareholder, or by an employer to an employee, for an amount substantially less than its fair market value, regardless of whether the transfer is in the guise of a sale or exchange, such shareholder or employee shall in-

clude in gross income the difference between the amount paid for the property and the amount of its fair market value to the extent that such difference is in the nature of (1) compensation for services rendered or to be rendered or (2) a distribution of earnings or profits taxable as a dividend, as the case may be. * * *

* * * * *

STATEMENT

In the Tax Court two cases with respect to the tax liability of Joseph Kane, hereinafter called the taxpayer, and a third case with respect to that of his wife, Rose Kane, were consolidated. (R. 22.) The facts as found by the Tax Court (R. 23–34) may be summarized as follows:

The taxpayer and his wife are residents of New York, N. Y. (R. 24.) Prior to the taxable years, the taxpayer lived in Cincinnati, Ohio, where he was a vice president of Gruen Watch Company, in charge of production. For the years 1940 to 1943, inclusive, he received salaries and bonuses aggregating from $20,000 to $34,000 a year. (R. 24–25.) On August 17, 1944, he entered into a written agreement to serve as assistant to the president of Bulova Watch Company, hereinafter called Bulova, in New York City. The agreement provided for the regular salary which the taxpayer would receive and also provided that he was to receive a percentage of Bulova's net profits. (R. 27–28.) On the same day that the taxpayer executed his contract with Bulova, his wife entered into a written agreement with Mr. Arde Bulova, chairman of the board of directors of Bulova, whereby she was

given the option to buy from him 1,000 shares of Bulova stock at the price of $37 per share, the option to be exercised as follows: 300 shares within the first year of the taxpayer's employment, 300 shares within the second year of his employment, and 400 shares within the third year of his employment. (R. 25, 29.)

The parties stipulated that the option price of $37 per share for the Bulova stock was in excess of the market price on the date the contracts were signed by the taxpayer and his wife, respectively. (R. 30.)

On July 24, 1945, before the taxpayer's wife exercised her right to purchase 300 shares of Bulova stock, there was a split of the stock on the basis of two new shares for one old share. (R. 30.) As a result of this stock split, the option agreement gave the taxpayer's wife the right to purchase a maximum amount of 2,000 shares at $18.50 per share, 600 shares during the first and second years of the taxpayer's employment, and 800 shares during the third year. (R. 31.)

The taxpayer's wife exercised her option to purchase Bulova stock on the dates and in the amounts shown in the following table at a substantial reduction below the market price (R. 31):

Date option exercised	Number of shares acquired	Cost	Market value	Excess of market value over cost
Dec. 27, 1945	600	$11,100	$22,200	$11,200
Aug. 6, 1946	600	11,100	30,750	19,650
July 21, 1947	800	14,800	27,000	12,200
Total	2,000	37,000	80,050	43,050

She apparently used her own funds with which to purchase the Bulova stock. (R. 31, 32.) She kept

the stock in her own safe deposit box and received the dividends on that stock. (R. 32.)

The taxpayer received aggregate salary and bonus payments from Bulova in 1945, 1946, and 1947, in the approximate amounts of $34,000, $44,000 and $55,000, respectively. (R. 32.)

The Commissioner determined deficiencies against the taxpayer for the years 1945, 1946, and 1947 in the aggregate amount of about $32,000, on the ground that he realized income in the amounts of $11,100, $19,650, and $12,200, respectively, for the years in question through the exercise of the option by his wife, to the extent of the difference between the option price and the market price. (R. 24, 32–33.)

For the year 1945 the taxpayer's wife reported, as ordinary income, gain from the exercise of a stock option in the amount of $11,100. She did not report any gain from the exercise of a stock option in her income tax returns for 1946 or 1947. The Commissioner determined a deficiency against her for the year 1947[2] on the ground that she realized income in the amount of $12,200 upon the exercise of an option to buy 800 shares of Bulova stock at a price $12,200 less than the market price. (R. 33.) In the Tax Court, the Commissioner made it clear that the inconsistent deficiency asserted against the taxpayer's wife was only for the purpose of protecting the revenue in the event that it should ultimately be decided

[2] At the time when the Commissioner determined a deficiency for 1947, the statute of limitations had run for the year 1946. The taxpayer's wife has filed a claim for refund as to the year 1945, action in which has been deferred pending the outcome of this case.

that the income was not taxable to the husband. (R. 34.)

The Tax Court found that the option to purchase Bulova stock was given to the taxpayer's wife as an inducement to him to accept the position of assistant to the president of Bulova in 1944 and to continue in the employ of the company and that the option was intended to provide additional compensation to the taxpayer in each year in which it was exercised. The Tax Court also found that the option was not intended to provide the taxpayer's wife with a proprietary interest in the company; and that in each of the years 1945, 1946 and 1947, the taxpayer realized additional compensation for his services in the amount of the excess of the market value of the Bulova stock over the option price paid for the acquisition of stock. (R. 34.) The Tax Court sustained the Commissioner's determination of deficiencies against the taxpayer and reversed the Commissioner's determination against the taxpayer's wife. (R. 43.)

The Court of Appeals affirmed the decisions of the Tax Court in a *per curiam* opinion. (R. pp. 51–52.)

ARGUMENT

1. The decision of the court below is correct. Section 22 (a) of the Internal Revenue Code of 1939, *supra*, p. 2, provides in part that "gross income" includes income derived from "salaries, wages, or compensation for personal service, * * * of whatever kind and in whatever form paid." Section 29.22 (a)–1 of Treasury Regulations 111, *supra*, pp. 2-3, provides, in part, that if property is transferred by an

employer to an employee, for an amount substantially less than its fair market value, regardless of whether the transfer is in the guise of a sale or exchange, such employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value to the extent that such difference is in the nature of compensation for services rendered or to be rendered.

Whether the option in this case, although exercisable by the wife, was intended by all parties concerned as a means of affording additional compensation to the taxpayer, as the Commissioner contends, or whether it was given to the wife for reasons completely independent of the taxpayer's employment, as the taxpayer contends, presents a question of fact which has been resolved against the taxpayer by both courts below. Although the option was given to the employee's wife, and not directly to the employee, the two agreements (the employee's contract and that of his wife) were executed on the same day. There were references in the wife's agreement to the employee's agreement, and also an indication that the option depended upon his continued employment. From these facts the Tax Court could reasonably infer that the two agreements were part of the same transaction, and that the stock option was intended as part of the employee's compensation and was given to his wife with his assent. While there was some conflicting evidence on this, it was the function of the Tax Court to weigh the evidence, draw inferences, and pass on the credibility of the witnesses. *Elmhurst Cemetery Co.* v. *Commissioner,* 300 U. S. 37, 40; *Helvering* v.

Kehoe, 309 U. S. 277, 279; *Helvering* v. *Nat. Grocery Co.,* 304 U. S. 282, 294–295; cf. *United States* v. *Yellow Cab Co.,* 338 U. S. 338, 341. On the record, the Tax Court's conclusion may not reasonably be said to be clearly erroneous. Furthermore, the court below affirmed the decision of the Tax Court (R. pp. 51–52) and this Court has frequently observed that concurrent findings of both courts below are entitled to finality here. *Comstock* v. *Group of Investors,* 335 U. S. 211, 214, and cases cited.

The taxpayer's petition seeks to raise, for the first time in this Court, alternative questions concerning the amount of income which should be taxed to him. (Pet. 2–3, Questions III and IV.) Since these issues were not raised in the Court of Appeals, they will ordinarily not be considered by this Court. *Helvering* v. *Tex-Penn Co.,* 300 U. S. 481; *Helvering* v. *Minnesota Tea Co.,* 296 U. S. 378. At all events, the finding of the Tax Court to the effect that the compensation intended to be conferred on the taxpayer was the (R. 43) "economic benefit to be derived from the exercises of the option," rather than from the grant of the option, is conclusive against the taxpayer's contention (Pet. 13–14) that the Tax Court should not have held that the measure of the income was to be determined by the spread between option price and actual value of the stock on the date when the option was exercised. *Commissioner* v. *LoBue,* 351 U. S. 243, rehearing denied, 352 U. S. 859; *Commissioner* v. *Smith,* 324 U. S. 177, rehearing denied, 324 U. S. 695.

2. There is no conflict of decisions. In *Bogardus* v. *Commissioner*, 302 U. S. 34 (Pet. 10), the cash bonus was held to be a gratuity and not intended as compensation; the factual setting of this case is altogether different and the conclusion of both courts below that compensation for personal services was intended by the employer makes this an altogether different case. In *McNamara* v. *Commissioner*, 210 F. 2d 505 (C. A. 7th) (Pet. 11), the Court of Appeals reversed the Tax Court and held that the stock option was intended to be income to the employee when granted and not when exercised, as the Tax Court had decided. Assuming that the *McNamara* case was correctly decided, the facts there are so different from this case that no conflict exists. Thus, in that case the option was exercisable or transferable without regard to the taxpayer's employment and the option price was less than the value of the stock at the time when the option was granted. In the present case the exact opposite is true. In *Commissioner* v. *Reece*, 233 F. 2d 30 (C. A. 1st) (Pet. 12), the taxpayer made an absolute assignment of the right to receive patent royalties to his wife, whereas in this case the taxpayer's compensation for personal services is involved; this Court decided many years ago that a taxpayer could not avoid the income tax on his earnings through an assignment to his wife. *Lucas* v. *Earl*, 281 U. S. 111. *Palmer* v. *Commissioner*, 302 U. S. 63 (Pet. 13–14), deals with the question whether the issuance of stock-purchase rights should be treated as a distribution of corporate earnings, taxable as a dividend, and obviously has no direct application here.

CONCLUSION

The decision of the court below is clearly correct and there is no conflict of decisions. The petition for a writ of certiorari should be denied.

Respectfully submitted,

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IN THE

Supreme Court of the United States

OCTOBER TERM 1956

JOSEPH KANE,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

REPLY TO RESPONDENT'S BRIEF IN OPPOSITION

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

REPLY TO RESPONDENT'S BRIEF IN OPPOSITION

In respondent's memorandum in opposition to the granting of the writ, respondent makes two statements that are inaccurate. On page 4, he states that the parties stipulated that the option price of $37.00 per share for the Bulova stock was in excess of the market price on the date the contracts were signed by the taxpayer and his wife; whereas, the stipulation states that the option price was in excess of the market price *at the time the option was granted,* (p. 20, of Petition for Writ) which was not the date the option agreement was signed. See page 7 of Petition for Writ of Certiorari.

The respondent further states: "On July 24, 1945, before the taxpayer's wife exercised her right to purchase 300 shares of Bulova stock, there was a split-up of the stock on the basis of 2 new shares for 1 old share. As a result of this stock split, the option agreement gave taxpayer's wife the right to purchase a maximum amount of

2,000 shares at $18.50 per share, 600 shares during the first and second years of the taxpayer's employment and 800 shares during the third year."

This statement is inaccurate. No such provision is contained in the option agreement. Mr. Bulova allowed the taxpayer's wife to make such purchases because he felt this was the right thing to do despite the fact that the option agreement was silent with regard to stock dividends or split-ups either as to quantity of stock to be acquired or the price to be paid.

It is noteworthy that in his statement the respondent makes no reference to the fact that Rose Kane was never an employee of the Bulova Watch Co. Inc. or of Arde Bulova and that the petitioner was not an employee of Arde Bulova nor was he an employee of the Bulova Watch Co., Inc. at the time the option was granted to Rose Kane—and furthermore, that it was stipulated that neither Arde Bulova nor the Bulova Watch Co. Inc. had ever issued prior to March 31, 1947 an option to acquire Bulova Watch Co. Inc. stock to any employee of either.

Respondent argues since the Tax Court and the U. S. Court of Appeals for the Second Circuit decided that the option granted to Rose Kane was intended as compensation to Joseph Kane and that this conclusion was a finding of fact, that this Court should not pass on the correctness of such conclusion by granting to petitioner the requested Writ of Certiorari.

In reply, petitioner cites this Court's granting of Writs of Certiorari in the cases of *Commissioner of Internal Revenue* v. *LoBue,* 351 U. S. 243, and *Bogardus* v. *Commissioner of Internal Revenue,* 302 U. S. 34, although in each case the Board of Tax Appeals or the Tax Court of the United States, and the U. S. Court of Appeals were in agreement and the cases involved factual questions similar to those involved in the instant case.

In support of the decisions of the court below, the respondent states that "there were references in the wife's agreement to the employee's agreement, and also an indication that the option depended upon his continued employment."

Here again the respondent errs, for the option agreement makes no reference to the employee's agreement.

In fact, the option agreement with Mrs. Kane, reduced to writing on August 17, 1944, states at the outset: "As you know, we have been seeking to employ your husband, Joseph Kane, but he is hesitating in accepting employment in our Company because you do not desire to move your home to New York from Cincinnati, where you now reside."

These words certainly cannot be construed to support respondent's statement that the wife's agreement made references to the employee's agreement or that the option depended on petitioner's continued employment.

The fact that the Tax Court from alleged conflicting evidence arrived at a given conclusion does not mean that the Supreme Court may not set aside its findings of fact as contrary to the evidence.

The respondent asserts that the petitioner did not raise Questions III and IV in the courts below and that this is the first time that the issues are being raised.

The respondent is in error. In petitioner's reply brief filed with the U. S. Court of Appeals, there is the following argument on page 10: "Thus, even if it be assumed, though strenuously denied by Joseph Kane, that Joseph Kane was intended to be the initial recipient of the option, he did not hold the property right after August 17, 1944. The value accruing to said property right after that date should no longer be chargeable to Joseph Kane, particularly when the funds necessary to take advantage of the property right belonged to and the subsequent benefits of said property right were received by Rose Kane."

Further, on page 11 of petitioner's reply brief, there is stated: "It requires no citation beyond the U. S. Supreme Court ruling in *Palmer* v. *Commissioner of Internal Revenue,* 302 U. S. 63, 69, to establish that a purchase of property by an individual from an unrelated party does not result in gain or loss to the purchaser * * * * *".

Thus it is evident that this question was raised before the court below. In any case, the denial that any income arose to petitioner from the exercise of the option by Rose Kane would embrace the issue set forth in Question III.

The respondent is likewise in error when he asserts that Question IV was not raised in the courts below.

That the petitioner raised the question of amended Regulations in the Tax Court is evident from that Court's opinion when it stated, in part: "It is pointed out that the respondent does not contend that this amendment to Regulations 111, Section 29.22(a)-1 contained in T. D. 5507, dated April 12, 1946, 1946-1 CB 18, and elaborated upon in I. T. 3795, 1946-1, CB-15, apply to the stock option, which is involved in these proceedings. The respondent recognizes that the stock option granted by Arde Bulova was given on August 17, 1944, and accordingly it is a stock option granted prior to February 26, 1945." The issue involved in Question IV was also presented in oral argument to the court immediately below.

As a matter of public policy and to resolve an important question of statutory construction, this Court should take jurisdiction and grant petitioner's application for a Writ of Certiorari.

It is of great importance to note that the respondent does not challenge the correctness of the statements made by petitioner in support of Questions III and IV.

CONCLUSION

For the foregoing reasons, petitioner prays that a Writ of Certiorari be granted.

Respectfully,

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